

Cumulative Bulletin Notice 97-9; 1997-1 CB 365

December 31, 1996

[Code Secs. 23 and 137]

Adoption expenses: Credits: Exclusions

Sections 23 and 137, relating to certain adoption expenses, were added to the Internal Revenue Code by the Small Business Job Protection Act of 1996, Pub. L. 104-188. This notice provides general guidance concerning the tax credit under §23 for qualified adoption expenses paid or incurred by an individual, and the exclusion from gross income under §137 for amounts paid or expenses incurred by an employer for qualified adoption expenses under an adoption assistance program. Both the credit and the exclusion are effective for taxable years beginning after December 31, 1996. They both generally terminate after December 31, 2001 (except for the credit with respect to a child with special needs).

This notice is divided into six sections. Section I explains the adoption credit. Section II explains the exclusion from gross income under an adoption assistance program. Section III describes the coordination of the credit and the exclusion. Sections IV and V cover filing and reporting requirements and the effective dates of the credit and the exclusion, respectively. Section VI invites comments on future guidance regarding the credit and the exclusion.

I. Adoption Credit.

A. In General.

Section 23 provides an income tax credit for qualified adoption expenses paid or incurred by an individual in connection with the adoption of an eligible child. The phrase "paid or incurred" refers to the method of accounting (i.e., cash or accrual) of the individual. Under a dollar limitation, the maximum credit is \$5,000 (\$6,000 in the case of an adoption of a child with special needs). See section I.D.1. The credit is also subject to an income limitation which may reduce or eliminate the credit for any particular year. See section I.D.2. For the effective date and partial expiration date of the credit, see section V.

B. Eligible Child and Child with Special Needs.

1. In general.

An eligible child is any individual who, at the time a qualified adoption expense is paid or incurred, is under the age of 18, or is physically or mentally incapable of caring for himself or herself. For qualified adoption expenses paid or incurred after December 31, 2001, an eligible child must also be a child with special needs.

2. Child with Special Needs.

A child with special needs is an otherwise eligible child who meets two additional requirements. First, a state must have determined that (1) the child cannot or should not be returned to the parents' home, and (2) it is reasonable to conclude the child cannot be placed with adoptive parents without adoption assistance because of a specific factor or condition. Examples of a specific factor or condition include a child's ethnic background, age, membership in a minority or sibling group, medical condition, or handicap. Second, a child with special needs must be a citizen or resident of the United States. The term "United States" includes any possession of the United States.

C. Qualified Adoption Expenses.

"Qualified adoption expenses" include the reasonable and necessary adoption fees, court costs, attorney's fees, traveling expenses (including amounts expended for meals and lodging) while away from home, and other expenses that are directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer. Qualified adoption expenses do not include any expense (1) for which a deduction or credit is allowed under any other provision of the Code, (2) to the extent that funds for the expense are received under any federal, state, or local program, (3) that is incurred in violation of federal or state law, (4) that is incurred in carrying out any surrogate parenting arrangement, (5) that is incurred in connection with the adoption of a child of the taxpayer's spouse, or (6) for which reimbursement is made under an employer program or otherwise. In addition, an expense paid (by a cash basis taxpayer) or incurred (by an accrual basis taxpayer) in a taxable year beginning before 1997 is not a qualified adoption expense eligible for the credit.

D. Limitations on the Credit.

The credit for qualified adoption expenses is subject to a dollar limitation and an income limitation.

1. Dollar Limitation.

The maximum amount of qualified adoption expenses that may be taken into account for the credit is \$5,000 (\$6,000 in the case of an adoption of a child with special needs). The legislative history to this provision clarifies that the \$5,000 (or \$6,000) limitation is with respect to the adoption of each child and is cumulative over all taxable years (rather than an annual limitation). See section I.G., Examples 1 and 2. Therefore, the maximum amount that may be taken into account in connection with a taxpayer's effort to adopt an eligible child is \$5,000 (or \$6,000), including qualified adoption expenses paid or incurred in any unsuccessful attempt to adopt an eligible child before successfully finalizing the adoption of another eligible child. See section I.G., Example 3. The \$5,000 (or \$6,000) limitation on qualified adoption expenses applies both to married individuals and to unmarried individuals adopting an eligible child. Therefore, an unmarried couple that seeks to adopt an eligible child must apply the \$5,000 (or \$6,000) limitation to the couple's combined qualified adoption expenses.

2. Income Limitation.

If a taxpayer's modified adjusted gross income (modified AGI, as defined in section I.D.3. below) is \$75,000 or less, the income limitation does not apply and the taxpayer's allowable credit is not reduced. If a taxpayer's modified AGI is \$115,000 or more, no credit is available. If a taxpayer's modified AGI is between \$75,000 and \$115,000, the allowable credit is ratably reduced (but not below zero) as follows:

$$\text{ALLOWABLE CREDIT} = \text{QAE(YR)} - [\text{QAE(YR)} \times (\text{[modified AGI} - \$75,000] \text{ OVER } \$40,000)]$$
"QAE(YR)" is the amount of qualified adoption expenses taken into account for the taxable year after applying the dollar limitation.

For example, assume that in 1997 an unmarried individual has modified AGI of \$85,000 and pays \$5,000 for qualified adoption expenses. The adoption becomes final in 1997. The individual's reduction percentage is 25% (\$85,000 minus \$75,000 equals \$10,000; \$10,000 divided by \$40,000 equals 25%). The maximum credit available is \$3,750 (\$5,000 times 25% equals \$1,250; \$5,000 minus \$1,250 equals \$3,750) and is claimed in 1997. In addition, see section I.G., Example 4.

3. Modified Adjusted Gross Income.

Modified AGI for the taxable year in which qualified adoption expenses are taken into account is adjusted gross income for that year determined after applying the income exclusion under §137, but without applying §911 (the foreign earned income exclusion or the foreign housing exclusion), §931 (the exclusion for income from Guam, American Samoa, and the Northern Mariana Islands), and §933 (the exclusion for income from Puerto Rico).

E. Year of Credit.

1. Domestic adoptions.

The credit for qualified adoption expenses paid or incurred in connection with the adoption of an eligible child who is a citizen or resident of the United States at the time the adoption commenced (including such amounts paid or incurred in an unsuccessful effort to adopt such a child) is allowed in the next taxable year unless the expenses are paid or incurred in the taxable year the adoption becomes final. The credit for expenses paid or incurred in the taxable year an adoption becomes final is allowed in that year.

2. Foreign adoptions.

A special rule applies in the case of the adoption of an eligible child who is not a citizen or resident of the United States at the time the adoption commenced. The credit is only available for adoptions that become final. Qualified adoption expenses paid or incurred in any taxable year before the taxable year in which the adoption becomes final are treated as paid or incurred in the taxable year in which the adoption becomes final. Therefore, the credit for qualified adoption expenses paid or incurred in the taxable year in which the adoption becomes final, or in any earlier taxable year, is allowed in the taxable year the adoption becomes final.

For example, assume that in 1997 and 1998 an unmarried individual pays \$1,000 and \$3,000, respectively, of qualified adoption expenses in connection with the adoption of an eligible child who is not a citizen or resident of the United States. In 1999, the year the adoption becomes final, the individual pays an additional \$4,000 of such expenses. The individual's modified adjusted gross income for 1999 is less than \$75,000 (and thus the income limitation does not apply). The individual may claim a credit of \$5,000 (the maximum credit permitted) on his or her 1999 federal income tax return (the year the adoption becomes final).

3. Pre-1997 Expenses.

An expense paid (by a cash basis taxpayer) or incurred (by an accrual basis taxpayer) in a taxable year beginning before 1997 in connection with the adoption (either domestic or foreign) of an eligible child does not qualify for the credit. See section V.A.

F. Carryforward of Unused Credit.

The adoption credit allowable under §23 is a nonrefundable credit that, along with credits allowable under §21 (relating to dependent care), §22 (relating to the elderly and the disabled), and §25 (relating to interest on home mortgages), is limited under §26 to the excess of the taxpayer's regular tax liability for the taxable year over the tentative minimum tax for the taxable year (determined without regard to the alternative minimum tax foreign tax credit). If §26 limits the amount of an adoption credit otherwise allowable in a particular year, the excess may be carried forward to the succeeding taxable year, but not beyond the fifth taxable year following the taxable year in which the credit arose.

G. Examples.

The following examples illustrate the rules described in section I. For purposes of these examples, except as otherwise provided, assume that each eligible child is a citizen of the United States who is not a child with special needs, and that H and W are a married couple who file a joint federal income tax return on the cash basis and seek to adopt one child.

Example 1. Dollar limitation. In an effort to adopt an eligible child, H and W pay \$4,000 of qualified adoption expenses in 1997 and an additional \$2,000 of qualified adoption expenses in 1998. The adoption becomes final in 1998. For 1998, H and W have modified AGI of \$75,000 or less (and thus the income limitation does not apply). H and W may not claim any qualified adoption expenses as a credit in 1997 because of the 1-year delay rule in section I.E.1. H and W, on their joint federal income tax return for 1998, may claim \$5,000 of qualified adoption expenses as a credit. The remaining \$1,000 of qualified adoption expenses H and W paid may never be claimed as a credit.

Example 2. Dollar Limitation. Assume the same facts as in Example 1, except that the child is a child with special needs. H and W, on their joint federal income tax return for 1998, may claim \$6,000 of qualified adoption expenses as a credit.

Example 3. Dollar limitation. In an effort to adopt an eligible child, H and W pay \$3,000 of qualified adoption expenses in January 1997 to Agency 1. Although Agency 1 was able to identify an eligible child for H and W to adopt, the adoption ultimately was unsuccessful. H and W then paid \$4,000 of qualified adoption expenses to Agency 2 in September 1997 in a further effort to adopt a child. This time, the effort was successful and H and W finalized the adoption of A, an eligible child, in December 1997. H and W have modified AGI of \$75,000 or less (and thus the income limitation does not apply). The total amount that H and W may take into account in connection with the adoption of an eligible child is limited to \$5,000. See section I.D.1. Thus, H and W, on their 1997 joint federal income tax return, may claim \$5,000 of qualified adoption expenses as a credit. The remaining \$2,000 of qualified adoption expenses H and W paid may never be claimed as a credit.

Example 4. Income limitation. In an effort to adopt an eligible child, H and W pay \$1,000 of qualified adoption expenses in 1997, an additional \$2,000 of those expenses in 1998, and \$4,000 of those expenses in 1999 when the adoption becomes final. H and W have modified AGI of \$85,000 for all taxable years and thus the income limitation applies. H and W may not claim any qualified adoption expenses as a credit in 1997 because of the 1-year delay rule in section I.E.1. H and W, on their 1998 joint federal income tax return, may take into account the \$1,000 of qualified adoption expenses paid in 1997, subject to any reduction under the income limitation. H and W's reduction percentage for 1998 under the income limitation is 25% (\$85,000 minus \$75,000 equals \$10,000; \$10,000 divided by \$40,000 equals 25%). H and W's allowable credit for 1998 is \$750 (\$1,000 times 25% equals \$250; \$1,000 minus \$250 equals \$750).

H and W, on their joint federal income tax return for 1999, first reduce the dollar limitation (\$5,000) by the amount of qualified adoption expenses taken into account in all prior years (\$5,000 minus \$1,000 equals \$4,000) before applying the income limitation. Thus, H and W may take into account only \$4,000 of the \$6,000 of qualified adoption expenses paid in 1998 and 1999 on their 1999 joint federal income tax return before applying the income limitation. H and W's reduction percentage for 1999 under the income limitation is 25% and their allowable credit for 1999 is \$3,000 (\$4,000 times 25% equals \$1,000; \$4,000 minus \$1,000 equals \$3,000). The remaining \$2,000 of qualified adoption expenses that H and W paid in 1998 and 1999 (\$6,000 minus \$4,000 equals \$2,000) may never be claimed as a credit.

II. Adoption Assistance Program.

A. In General.

Section 137 provides an exclusion from an employee's gross income for amounts paid or expenses incurred by an employer for qualified adoption expenses in connection with the adoption of an eligible child by an employee if such amounts are furnished pursuant to an adoption assistance program. See section II.D., which describes the requirements of an adoption assistance program. Under a dollar limitation, the maximum exclusion from gross income is \$5,000 (\$6,000 in the case of an adoption of a child with special needs). See section II.F.1. The exclusion is also subject to an income limitation, which may reduce or eliminate the exclusion for any particular year. See section II.F.2. For the effective date and expiration date of the exclusion, see section V.

B. Eligible Child and Child with Special Needs.

1. In General.

An eligible child is any individual who, at the time a qualified adoption expense is paid or incurred, is under the age of 18, or is physically or mentally incapable of caring for himself or herself.

2. Child with Special Needs.

A child with special needs is an otherwise eligible child who meets two additional requirements. First, a state must have determined that (1) the child cannot or should not be returned to the parents' home, and (2) it is reasonable to conclude the child cannot be placed with adoptive parents without adoption assistance because of a specific factor or condition. Examples of a specific factor or condition include a child's ethnic background, age, membership in a minority or sibling group, medical condition, or handicap. Second, a child with special needs must be a citizen or resident of the United States. The term "United States" includes any possession of the United States.

C. Qualified Adoption Expenses.

"Qualified adoption expenses" include the reasonable and necessary adoption fees, court costs, attorney's fees, traveling expenses (including amounts expended for meals and lodging) while away from home, and other expenses that are directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer. Qualified adoption expenses do not include any expense (1) that is incurred in violation of federal or state law, (2) that is incurred in carrying out any surrogate parenting arrangement, (3) that is incurred in connection with the adoption of a child of the taxpayer's spouse, or (4) that is reimbursed other than under an adoption assistance program that satisfies the requirements of §137.

D. Adoption Assistance Program Requirements.

1. In General.

An adoption assistance program is a separate written plan of an employer for the exclusive benefit of its employees under which the employer provides adoption assistance and which meets the requirements described below. The exclusion is not available unless, before adoption expenses are incurred by either the employer or employee, the written plan is in existence and the employee receives notification of the existence of the plan. An adoption assistance program may be part of a more comprehensive benefit plan and is not required to be funded. In addition, an employer is not required to apply to the Internal Revenue Service for a determination that the plan is a qualified program.

2. Plan Requirements.

A brief description of the plan requirements follows:

(a) all employees who are eligible to participate in the program are required to be given reasonable notice of the terms and availability of the program;

(b) an adoption assistance program must benefit the employer's employees generally and eligibility requirements may not discriminate in favor of highly compensated employees or their dependents;

(c) shareholders or owners (or their spouses or dependents) may receive no more than five percent of all the adoption assistance reimbursements or expenses paid by the employer during the year (for this purpose, a shareholder or owner is someone who owns on any day of the year more than five percent of the stock, or capital or profits interest of the employer); and

(d) an employee receiving payments under an adoption assistance program must provide the employer reasonable substantiation that payments or reimbursements made under the program constitute qualified adoption expenses.

Without regard to whether the foregoing requirements are satisfied, adoption reimbursement programs under §1052 of title 10, United States Code (relating to the armed forces) or §514 of title 14, United States Code (relating to members of the Coast Guard) are treated as adoption assistance programs for purposes of the exclusion.

E. Cafeteria Plans.

An adoption assistance program that meets the requirements of §137 (described in section II.D.) constitutes a qualified benefit under *§125 of the Code*. Consequently, the program may be offered through a cafeteria plan.

F. Limitations on the Exclusion.

The exclusion from gross income for qualified adoption expenses under an adoption assistance program is subject to a dollar limitation and an income limitation.

1. Dollar Limitation.

The maximum amount of qualified adoption expenses that may be taken into account is \$5,000 (\$6,000 in the case of an adoption of a child with special needs). The \$5,000 (or \$6,000) limitation is with respect to the adoption of each child and is cumulative over all taxable years (rather than an annual limitation). See section II.J., Examples 1 and 2. Therefore, the maximum amount that may be taken into account in connection with a taxpayer's effort to adopt an eligible child is \$5,000 (or \$6,000), including amounts paid or expenses incurred for qualified adoption expenses in connection with any unsuccessful attempt to adopt an eligible child before successfully finalizing the adoption of another eligible child. See section II.J., Example 3. The \$5,000 (or \$6,000) limitation on qualified adoption expenses applies both to married individuals and to unmarried individuals adopting an eligible child. Therefore, an unmarried couple that seeks to adopt an eligible child must apply the \$5,000 (or \$6,000) limitation to the couple's combined qualified adoption expenses.

2. Income Limitation.

If a taxpayer's modified adjusted gross income (modified AGI) (as defined in section II.F.3. below) is \$75,000 or less, the income limitation does not apply and the taxpayer's allowable exclusion is not reduced. If a taxpayer's modified AGI is \$115,000 or more, no exclusion is available. If a taxpayer's modified AGI is between \$75,000 and \$115,000, the allowable exclusion is ratably reduced (but not below zero) as follows:

ALLOWABLE EXCLUSION = QAE(YR) - [QAE(YR) x ([modified AGI - \$75,000] OVER [\$40,000])] "QAE(YR)" is the amount of qualified adoption expenses taken into account for the taxable year after applying the dollar limitation.

For example, assume that in 1997 an unmarried employee has modified AGI of \$85,000 and is reimbursed \$5,000 by his or her employer under an adoption assistance program for qualified adoption expenses. The employee's reduction percentage is 25% (\$85,000 minus \$75,000 equals \$10,000; \$10,000 divided by \$40,000 equals 25%). The maximum amount of the exclusion from the employee's gross income in 1997 is \$3,750 (\$5,000 times 25% equals \$1,250; \$5,000 minus \$1,250 equals \$3,750). The remaining \$1,250 is included in the employee's gross income for 1997. In addition, see section II.J., Example 4. For the employee's tax filing obligations and responsibilities, see section II.G.2.

3. Modified adjusted gross income.

Modified AGI for the taxable year in which the exclusion may be claimed is adjusted gross income for that year, but without applying §137 (the exclusion for adoption assistance program payments), §911 (the foreign earned income exclusion or the foreign housing exclusion), §931 (the exclusion for income from Guam, American Samoa, and the Northern Mariana Islands), and §933 (the exclusion for income from Puerto Rico). Modified AGI as defined for the exclusion is different from modified AGI as defined for the credit.

G. Tax Withholding, Reporting, and Filing Obligations.

1. Employer's Withholding and Reporting Obligations.

Amounts paid or expenses incurred by an employer for qualified adoption expenses under an adoption assistance program are not subject to income tax withholding. However, these amounts are subject to social security and Medicare taxes (FICA), federal unemployment tax (FUTA), and railroad retirement tax withholding. Employers are to report amounts paid or expenses incurred for qualified adoption expenses in accordance with appropriate forms (for example, Form W-2) and instructions or other guidance issued by the Internal Revenue Service. See Announcement 96-134, *1996-53 I.R.B. 1*, for instructions relating to reporting adoption assistance program payments on Form W-2.

2. Employee's Tax Filing Obligations and Responsibilities.

As described above, amounts paid or expenses incurred for qualified adoption expenses by an employer under an adoption assistance program are not subject to income tax withholding.

Therefore, an employee who receives reimbursements or payments that do not qualify, or only partially qualify, for the exclusion from gross income (see sections II.F.2. and II.H.2.) must make an appropriate adjustment on Form 1040 (in accordance with the form and its instructions) to include in gross income the taxable portion of the reimbursement. In addition, the employee may need to make an adjustment to his or her income tax withholding (on Form W-4) or make estimated tax payments (see Publication 505, Tax Withholding and Estimated Tax) to avoid potential penalties for underpayment of tax on the taxable portion of a reimbursement.

H. Year of Exclusion.

1. Domestic Adoptions.

In general, amounts are excludable from the employee's gross income for the year in which the employer pays the qualified adoption expense in connection with the adoption of an eligible child who is a citizen or resident of the United States at the time the adoption commenced.

2. Foreign Adoptions.

A special rule applies in the case of the adoption of an eligible child who is not a citizen or resident of the United States at the time the adoption commenced. The exclusion is only available for adoptions that become final. Amounts paid or expenses incurred by the employer for qualified adoption expenses before the taxable year in which the adoption becomes final are excludable from the employee's gross income in the taxable year in which the adoption becomes final. Therefore, amounts paid or expenses incurred by the employer under an adoption assistance program in a taxable year prior to a final adoption are includible in the employee's gross income in that year. The employee must make an appropriate adjustment on the employee's Form 1040. Provided the adoption becomes final before January 1, 2002, the employee may claim the exclusion in the taxable year in which the adoption becomes final by making an appropriate adjustment on the employee's Form 1040 for that year. See section II.J., Example 5. See also section II.G. for employer and employee tax withholding, reporting, and filing obligations.

I. Reserved.

J. Examples.

The following examples illustrate the rules described in section II. For purposes of these examples, except as otherwise provided, assume that each eligible child is a citizen of the United States who is not a child with special needs, that Employee Y is married, is a cash method taxpayer, and files a joint federal income tax return with Y's spouse. Y and Y's spouse seek to adopt one child. Also assume that Employer X establishes an adoption assistance program that meets the requirements of §137 on January 1, 1997, and that Y is a plan participant.

Example 1. Dollar limitation. In 1997, pursuant to the adoption assistance program, X pays \$5,000 of qualified adoption expenses on behalf of Y in connection with Y's effort to adopt an eligible child. Y and Y's spouse have modified AGI of \$75,000 or less for 1997 and 1998 (and thus the income limitation does not apply). In 1997, Y can exclude \$5,000 from gross income. In 1998, X

pays an additional \$2,000 of qualified adoption expenses on behalf of Y. Y must include the additional amounts in gross income in 1998. See section II.G. for X and Y's tax withholding, reporting, and filing obligations.

Example 2. Dollar limitation. Assume the same facts as in Example 1, except that the child is a child with special needs. In 1997, Y can exclude \$5,000 from gross income. In 1998, Y can exclude an additional \$1,000 from gross income. Y must include the remaining \$1,000 in gross income in 1998. See section II.G. for X and Y's tax withholding, reporting, and filing obligations.

Example 3. Dollar limitation. In 1997, pursuant to the adoption assistance program, X pays \$7,000 of qualified adoption expenses on behalf of Y in connection with Y's effort to adopt an eligible child (\$3,000 of qualified adoption expenses to Agency 1 for an unsuccessful attempt to adopt A and \$4,000 of qualified adoption expenses to Agency 2 for the final adoption of B). Y and Y's spouse have modified AGI of \$75,000 or less for 1997 (and thus the income limitation does not apply). The total amount that Y may take into account in connection with the adoption of an eligible child is limited to \$5,000. Thus, in 1997, Y can exclude \$5,000 from gross income. See section II.F.1. The remaining \$2,000 of qualified adoption expenses X paid on behalf of Y are includible in Y's gross income in 1997. See section II.G. for X and Y's tax withholding, reporting, and filing obligations.

Example 4. Income limitation. Pursuant to the adoption assistance program, X pays \$3,000 of qualified adoption expenses in 1997, and \$4,000 of those expenses in 1998 on behalf of Y in connection with Y's effort to adopt an eligible child. Y and Y's spouse have modified AGI of \$85,000 for all taxable years (and thus the income limitation applies). In 1997, Y can exclude \$2,250 from income. The income limitation reduces the maximum exclusion as follows: Y's reduction percentage is 25% [$\$85,000$ minus $\$75,000$ equals $\$10,000$; $\$10,000$ divided by $\$40,000$ equals 25%]; $\$3,000$ times 25% equals $\$750$; $\$3,000$ minus $\$750$ equals $\$2,250$. In 1998, the income limitation reduces the maximum exclusion as follows: the dollar limitation ($\$5,000$) is reduced by the amount of qualified adoption expenses taken into account for the exclusion in all prior years ($\$3,000$ in 1997). Thus, of the $\$4,000$ of qualified adoption expenses paid in 1998, Y may take into account only $\$2,000$ ($\$5,000$ minus $\$3,000$ equals $\$2,000$) before applying the income limitation. Y's reduction percentage is 25% and Y can exclude $\$1,500$ from income in 1998 ($\$2,000$ times 25% equals $\$500$; $\$2,000$ minus $\$500$ equals $\$1,500$). See section II.G. for X and Y's tax withholding, reporting, and filing obligations.

Example 5. Cafeteria Plan. Assume that for 1997, Y elects \$2,400 in adoption assistance offered under a calendar year cafeteria plan maintained by X. In December 1997, Y submits, and X reimburses, a claim of \$2,400 for qualified adoption expenses incurred by Y for services provided in 1997 in connection with a foreign adoption. The adoption becomes final in 1998. Y and Y's spouse have modified adjusted gross income of \$75,000 or less in 1998 (and thus the income limitation does not apply). Y is required to include the \$2,400 reimbursement in gross income for the 1997 tax year (because of the rules in section II.H.2.). However, Y is entitled to exclude \$2,400 (the reimbursement received in 1997) from gross income for the 1998 tax year (the year the adoption becomes final) by making an appropriate adjustment to Y's Form 1040 for 1998. See section II.G. for X and Y's tax withholding, reporting, and filing obligations.

III. Coordination of Credit and Exclusion.

A. Credit or Exclusion.

An individual may claim both a credit and an exclusion in connection with the adoption of an eligible child. An individual may not, however, claim both a credit and an exclusion for the same expense. For example, assume that in 1997 an unmarried individual pays \$6,500 in qualified adoption expenses to an adoption agency for the final adoption of an eligible child who is not a child with special needs. In that same year, the individual's employer, under an adoption assistance program that satisfies the requirements of §137, pays an additional \$5,000 for other qualified adoption expenses to a private attorney on behalf of the employee for the adoption of the child. In 1997, assuming the individual's modified AGI is \$75,000 or less, the individual may exclude \$5,000 from gross income, and may claim a credit of \$5,000, because the exclusion and credit are not for the same expenses. The remaining \$1,500 of qualified adoption expenses may never be claimed as a credit or excluded from gross income.

B. No Credit for Employer Payments.

An individual may not claim a credit for any expense reimbursed by the individual's employer, whether or not reimbursed under an adoption assistance program. See section I.C. For example, assume that in 1997 an unmarried individual pays \$1,000 in qualified adoption expenses to a private attorney for the final adoption in that year of an eligible child who is not a child with special needs. In the same year, the individual's employer, under an adoption assistance program that satisfies the requirements of §137, pays an additional \$7,000 in qualified adoption expenses to an adoption agency on behalf of the employee. Assuming the individual's modified AGI for 1997 is \$75,000 or less, the individual may exclude \$5,000 (of the \$7,000 paid by the employer) from gross income, and may claim a credit for the \$1,000 paid by the individual. The remaining \$2,000 of adoption expenses paid by the employer may never be claimed as a credit (nor excluded), and must be included in the individual's gross income in 1997.

IV. Filing and Reporting.

A. In General.

Taxpayers will be required to provide (on a form to be published by the Internal Revenue Service) available information about the name, age, and taxpayer identification number (TIN) of each eligible child for whom qualified adoption expenses are taken into account for purposes of the credit or exclusion. In lieu of such information, taxpayers may be required to furnish other information, including identification of the agent assisting with the adoption. Taxpayers should maintain records to support any adoption credit or exclusion claimed.

B. Married Individuals.

Individuals who are married at the end of the taxable year must file a joint federal income tax return to claim the credit or the exclusion unless they lived apart from each other for the last six months of the taxable year and the individual claiming the credit or the exclusion (1) maintained as his or her home a household for the eligible child for more than one-half of the taxable year, and (2) furnished

over one-half of the cost of maintaining that household in that taxable year. For this purpose, an individual legally separated from his or her spouse under a decree of divorce or separate maintenance will not be considered married.

C. Forms and Instructions.

The Service will publish forms and instructions with respect to the filing requirements for individuals and the reporting requirements for employers.

V. Effective Dates of the Credit and the Exclusion.

A. Effective Date.

Both the credit and the exclusion are effective for taxable years beginning after December 31, 1996.

B. Expiration Date.

The credit under §23 for qualified adoption expenses in connection with the adoption of an eligible child who is not a child with special needs expires for expenses paid or incurred after December 31, 2001. Therefore, no credit is available for those expenses paid (by a cash method taxpayer) or incurred (by an accrual method taxpayer) after December 31, 2001. The credit for qualified adoption expenses paid or incurred in connection with an adoption of an eligible child with special needs does not expire.

The exclusion under §137 for adoption assistance expires after December 31, 2001. Therefore, no exclusion from gross income applies to amounts paid or expenses incurred under an adoption assistance program after December 31, 2001.

In the case of a foreign adoption that becomes final after December 31, 2001, taxpayers cannot receive either a credit or an exclusion.

VI. Comments on Future Guidance Invited.

The Service invites comments on future guidance concerning §§23 and 137. The Service requests that written comments be submitted by [INSERT DATE THAT IS [90] DAYS AFTER DATE OF PUBLICATION OF THIS DOCUMENT IN THE INTERNAL REVENUE BULLETIN]. Send submissions to: CC:DOM:CORP:R (Notice 97- 9), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Notice 97-9), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet directly to the IRS internet site at http://www.irs.ustreas.govprodtax_regcomments.html.

The principal authors of this notice are Marilyn E. Brookens of the Office of the Assistant Chief Counsel (Income Tax and Accounting), and Sharon Cohen and Catherine Fuller of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). For further information

regarding the tax credit portion of the notice, contact Ms. Brookens at (202) 622-4920 (not a toll-free call). For further information regarding the adoption assistance program portion of the notice, contact Ms. Cohen or Ms. Fuller on (202) 622-6080 (not a toll-free call).

Cumulative Bulletin Notice 97-70; I.R.B. 1997-49, 9

November 24, 1997

[Code Sec. 23]

Adoption expenses: Credit: Year allowed: Domestic v. foreign
adoptions

This notice modifies Notice 97-9, 1997-2 *I.R.B.* 35, which provides, in part, general guidance concerning the income tax credit under §23 of the *Internal Revenue Code* for qualified adoption expenses paid or incurred by an individual. Notice 97-9 is modified to incorporate the amendment made to §23(a)(2) (relating to the year(s) in which the credit for certain qualified adoption expenses is allowed) by §1601(h)(2)(A) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 1092 (1997), effective for taxable years beginning after December 31, 1996. Notice 97-9 will appear in 1997-1 C.B. as modified by this notice.

Section I.E.1 and the first paragraph of section I.E.2 of Notice 97-9 are modified to read as follows:

E. Year of Credit.

1. Domestic adoptions.

The credit for qualified adoption expenses paid or incurred to adopt an eligible child who is a citizen or a resident of the United States at the time the adoption commenced (including such amounts paid or incurred in an unsuccessful effort to adopt such a child) is allowed in the next taxable year unless the expenses are paid or incurred during or after the taxable year the adoption becomes final. The credit for qualified adoption expenses paid or incurred during or after the taxable year in which an adoption becomes final is allowed in the taxable year in which the expenses are paid or incurred.

2. Foreign adoptions.

A special rule applies in the case of the adoption of an eligible child who is not a citizen or resident of the United States at the time the adoption commenced. The credit is only available for adoptions that become final. Qualified adoption expenses paid or incurred in any taxable year before the taxable year in which the adoption becomes final are treated as paid or incurred in the taxable year in which the adoption becomes final. Therefore, the credit for qualified adoption expenses paid or incurred in the taxable year in which the adoption is final, or in any earlier taxable year, is allowed in the taxable year the adoption becomes final. The credit for qualified adoption expenses paid or incurred after the taxable year in which the adoption becomes final is allowed in the taxable year in which the expenses are paid or incurred.

The principal author of this notice is Marilyn E. Brookens of the Office of the Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Ms. Brookens at (202) 622-4920 (not a toll-free call).

IRS Announcement

IRS Announcement 97-64; I.R.B. 1997-26, 9.

June 30, 1997

[Code Secs. 23, 125 and 137]

Adoption benefits: Employer-provided: Instructions for
reporting: 1997 Form W-2

This announcement is to clarify the instructions for reporting the 1997 employer-provided adoption benefits under code T in box 13 of Form W-2.

Report the total amount paid or reimbursed by an employer for qualified adoption expenses furnished to an employee under an adoption assistance program. Also include adoption benefits paid or reimbursed from the pre-tax contributions made by the employee to a section 125 (cafeteria) plan. However, do not include adoption benefits forfeited from a section 125 (cafeteria) plan.

Report in box 13 the total benefits paid or reimbursed, including any in excess of the \$5,000 or \$6,000 exclusion.